IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1978

NO. 78-700

HERMAN AND MARY E. McKINNEY,
Petitioners,

V.

UNITED STATES OF AMERICA,
Respondent

PETITION FOR A WRIT OF
CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE
FIFTH CIRCUIT

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The Petitioners, Herman and Mary E. McKinney, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on July 31, 1978.

OPINIONS BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix at p. 11a. The opinion of the District Court for the Western District of Texas, reported at 76-2 USTC ¶ 9728, appears in the Appendix at p. 1a.

JURISDICTION

The opinion of the Court of Appeals for the Fifth Circuit denying the Petition for Rehearing was entered on July 31, 1978. This Court's jurisdiction is invoked under 28 U.S.C. § 1254.

QUESTION PRESENTED

Whether an embezzler holds embezzled funds "under a claim of right" and qualifies for Internal Revenue Code Section 1341.

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code Section 1341, in pertinent part:

> Computation of tax where taxpayer restores substantial amount held under a claim of right
>
> . . . (a) GENERAL RULE--If--
>
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

> (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> (4) the tax for the taxable year computed with such deduction; or
>
> (5) an amount equal to--
>
> (A) the tax for the taxable year computed without such deduction, minus
>
> (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

STATEMENT OF THE FACTS

This dispute arises from the Internal Revenue Service's disallowance of a claim for refund. Petitioner Herman E. McKinney embezzled $91,702.06 in 1966 from his employer, the Texas Employment Commission. He reported and paid tax on this amount as miscellaneous income in his timely filed 1966 tax return. After

restoring the entire amount to the Commission in 1969, petitioner filed a claim for refund under Internal Revenue Code Section 1341. The District Director based disallowance of the claim on the contention that petitioner did not hold the funds under a claim of right in 1966. Following exhaustion of administrative remedies, petitioner instituted this action for refund pursuant to 28 U.S.C. § 1346(a)(1), in the U.S. District for the Western District of Texas. The parties stipulated prior to trial that the only legal issue related to Section 1341 was whether petitioner had a claim of right to the embezzled funds. Despite this stipulation, both the District Court and a three-judge panel of the Fifth Circuit based their decisions on whether the petitioner had an unrestricted right to the funds. Both courts held that Section 1341 was unavailable to petitioner because he did not have an unrestricted right to the embezzled money. Petitioner filed this petition for a writ of certiorari within ninety (90) days after denial of the petition for rehearing.

REASONS FOR GRANTING THE WRIT

1. The Fifth Circuit's decision conflicts with this Court's theory of "claim of right" in Healy.

To qualify for an adjustment under Section 1341 of the Internal Revenue Code, a taxpayer must have an unrestricted right to funds. The Internal

Revenue Service interprets this requirement in Treasury Regulation 1.1341-1(a)(2) to mean a taxpayer must hold the funds under a claim of right.[1/] Based on its belief that an embezzler does not have a claim of right to his gains, the Service has denied Section 1341 treatment to such a taxpayer. See Revenue Ruling 65-254. Yet, an analysis of the authority defining "claim of right" indicates that an embezzler, such as petitioner, comes under the doctrine and deserves the benefits of Section 1341.

In Healy v. Commissioner, 345 U.S. 278 (1958), this Court said that a "claim of right" arises when a taxpayer receives funds and treats them as his own; later invalidation of the claim is irrelevant, since the inquiry focuses on the existence, rather than the nature, of the claim. For that reason, even if the taxpayer's claim is illegitimate, the claim of right doctrine still applies. Consistent with this reasoning, the

---

1/ This Court set forth the claim of right doctrine in North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 (1932): a taxpayer must include in gross income any earnings received under a claim of right, even if his entitlement to the money is later disputed and he is forced to repay.

Court drew an analogy between the use of "claim of right" in taxation and its treatment in adverse possession. This Court has said that in adverse possession a claim of right is established by the possessor's intent to use the property as his own to the exclusion of others. Guaranty Title & Trust Co. v. U.S., 26 U.S. 200, 204 (1924). In Guaranty Title, this Court rejected the test of whether or not a claim of right was bona fide. Thus, the determinative issue in adverse possession is not the legitimacy of the claim, but the possessor's treatment of the property. By using adverse possession as a model for the "claim of right" doctrine in taxation, the Court indicated in Healy that it will ignore the legal status of the taxpayer's claim and look to the practical effect of his possession.

This view of "claim of right" is consistent with congressional intent as reflected by the legislative history of Section 1341. In 1958, Congress amended Section 1341 by inserting the requirement of "unrestricted right" in Section 1341(a)(1). The Senate Committee's technical explanation of the amendment indicates that "unrestricted right" refers to "unrestricted use." Senate Report 1983, 85th Cong. 2d Sess. 1958. Through this language Congress intended to expand Section 1341 to include accrual accounting taxpayers and not to limit its availability on the basis of the legitimacy of a claim.

The Fifth Circuit recognized this definition of claim of right in Bramlette Building Corp. v. Commissioner, 424 F.2d 751 (5th Cir. 1970). In that case, the Court found that a claim of right arose when a corporation collected and used funds from a parking lot owned by its president. The Court emphasized that the existence of a claim of right depends not on the claim's legitimacy, but on the taxpayer's treating the funds as its own. Id. at 753.

In the instant case, petitioner held the funds under a claim of right as defined in Bramlette and Healy. He treated the money as his own by depositing it in his bank account and investing it in Treasury bills. It is irrelevant for Section 1341 that he acquired the funds through embezzlement, since the legitimacy of his claim does not determine the existence of a claim of right. The Fifth Circuit's refusal to recognize a claim of right to embezzled funds in this case conflicts with the guidelines set forth by this Court, and therefore warrants review.

2. The Fifth Circuit's decision conflicts with this Court's extension of the "claim of right" doctrine to embezzled funds in James.

In James v. U.S., 366 U.S. 213 (1961), this Court held that an embezzler must include embezzled funds in his gross income. The Court reasoned

that Congress intended no difference of treatment between a lawbreaking taxpayer, and a "law-abiding taxpayer [who] mistakenly receives income in one year which receipt is assailed and found to be invalid in a subsequent year, [and] . . . must nonetheless report the amount as 'gross income' in the year received." Id. at 219-220. This explanation is but a restatement of "claim of right," though the Court did not mention it by name. The Fifth Circuit's decision in that case reflects a refusal to follow this extension of claim of right to embezzled funds as dictated by this Court in James. This departure from principles set forth in James necessitates review by this Court.

3. The Fifth Circuit's decision conflicts with the Seventh Circuit's extension of "claim of right" to embezzled funds in Quinn.

In Quinn v. Commissioner,[2/] 524 F.2d 617 (7th Cir. 1975), the Seventh Circuit made it clear that it considers embezzled funds to be held under a claim of right. The Court specifically referred to Section 1341 as alleviating the harshness of the claim of right doctrine. Quinn and the instant case create a situation whereby an embezzler suing in the Seventh Circuit will receive the benefits of Section 1341,

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2/ Quinn involved an embezzler who embezzled and repaid funds in the same year.

while his counterpart in the Fifth Circuit will not. Review by this Court is therefore necessary to settle the conflict between these Circuits.

For these reasons, the Writ of Certiorari should issue to review the decision below.

Respectfully submitted,

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CERTIFICATE OF SERVICE

Pursuant to Rule 33 of the Rules of the Supreme Court of the United States, this Petition for Writ of Certiorari has been delivered to the Solicitor General, Department of Justice, Washington D.C. 20530 by certified mail, return receipt requested.

DISTRICT COURT FOR THE
WESTERN DISTRICT OF TEXAS

Herman E. and Mary E. McKinney
v.
United States of America

September 30, 1976

MEMORANDUM OPINION AND ORDER

ROBERTS, District Judge: This is an income tax refund case which was tried before the Court in a non-jury trial on September 7, 1976. The Court, having carefully considered the facts stipulated by the parties, the evidence and arguments adduced at trial, and the pre-trial and post-trial briefs of the parties, is of the opinion that Plaintiffs are not entitled to the relief that they seek.

Plaintiffs in this case are husband and wife. Herman E. McKinney will be referred to as the Plaintiff, since his wife is a party to the proceedings only because she filed joint income tax returns with him for the years in question. Plaintiff embezzled $91,702.06 from his employer, Texas Employment Commission, in 1956, and he reported that amount as miscellaneous income on his 1966 tax return and paid the tax due on it. Subsequently, the embezzlement was discovered, Plaintiff was convicted in state court for the crime, and he repaid the embezzled money to his employer in 1969. Plaintiff claims that he is entitled to special tax treatment as a result of his repayment of the

embezzled funds that had been previously included in his income and taxed. Plaintiff claims that he was engaged in the trade or business of embezzling and is therefore entitled to a deduction under § 172 of the Internal Revenue Code for a net operating loss carryback to 1966 of the 1969 loss (caused by repayment of the embezzled funds in 1969) incurred in connection with his trade or business of embezzlement. Alternatively, Plaintiff contends that he acquired the embezzled funds under a claim of right so that the repayment of the embezzled funds in 1969 entitles him to the tax benefits of § 1341 of the Internal Revenue Code. The Government rejected these claims and allowed plaintiff to deduct the $91,702.06 on his 1969 tax return as a loss incurred in a transaction entered into for profit although not connected with a trade or business, pursuant to § 165 (c)(2) of the Code. Plaintiff then instituted a claim for refund on the basis that he was entitled to a refund on either his trade or business theory or his claim of right theory. The only factual question before the Court is whether or not the Plaintiff devoted enough time to his embezzlement schemes to make them constitute a trade or business, if embezzlement can ever constitute a trade or business as a matter of law. The two legal issues before the court are: (1) whether embezzlement can as a matter of law ever constitute a trade or business and (2) whether repayment of embezzled money is sufficient as a matter of law to come within the terms of § 1341 and its tax benefits.

At the trial, Plaintiff contended that his embezzlement constituted a trade or business. Plaintiff testified that during his high school years, 1924 to 1928, he engaged in a scheme to embezzle money from a high school concession operation and in fact successfully embezzled some amount between $1,00 and $2,000. Plaintiff also testified that he successfully embezzled approximately $58,000 from his employer, Texas Employment Commission, in 1956, and that the embezzlement scheme which is the subject of the instant suit constituted his third embezzlement. Plaintiff contended that he spent approximately fifty percent of all his working time between 1956 and 1966 carrying out the embezzlement scheme that resulted in the embezzlement of the $91,702.06 in 1966. On the strength of these three embezzlements, Plaintiff contended that he was in the trade or business of being an embezzler and as such his repayment of the embezzled money in 1969 constituted an expense connected with his trade or business, and thus, was deductible under § 172 net operating loss carryback provisions. On cross examination, the Government brought out the fact that no one knew of these embezzlements prior to the discovery of the last embezzlement in 1969, and that Plaintiff had told no one of any of these schemes. The government also brought out the fact that when Plaintiff reported the embezzled funds as income in 1966, they were reported as miscellaneous income, "windfall", rather than as income from a trade or business.

The Internal Revenue Code does not set out a definition of the term trade or business. There is some general agreement, however, on the requirements for what constitutes a trade or business under § 172 of the Code.

> Important considerations are (1) the continuity of the business (whether it is engaged in regularly or merely from time to time), (2) the amount of time and energy devoted thereto by the taxpayer, and (3) whether the taxpayer is engaged in earning a livelihood, in investment activities, in pursuit of pleasure, or an avocation. An isolated or occasional activity or transaction is not sufficient.

5 Mertens, *Law of Federal Income Taxation* (1975) § 29.06. Even assuming that embezzlement can theoretically be a trade or business for tax purposes, the Court does not find that Plaintiff's activities were sufficient to constiute a trade or business under § 172 of the Internal Revenue Code. Despite Plaintiff's claims, at best, Plaintiff was only an occasional embezzler, and his true trade or business was as an employee of the Texas Employment Commission. Plaintiff did not continuously engage in embezzlement as an attempt to earn a livelihood, but as an occasional lark, to see if he could successfully complete the crime. Furthermore, the Court is of the opinion that as a matter of law embezzlement is not a trade or business for § 172 purposes. Rev. Rule 65-254,

1965-2 Cum. Bull. 50. There are good policy reasons for not allowing trade or business treatment of repaid embezzled funds. To allow an embezzler to get the benefits of the § 172 net operating loss carryback would place him in a much more advantageous position tax wise than he would otherwise be in, and thus it would tend to encourage the commission of this crime. Such a result would be adverse to both policy and comity considerations. See *Tank Truck Rentals, Inc. v. Commissioner* [58-1 USTC ¶ 9366], 356 U. S. 30 (1958). Thus, the Court holds that as a matter of law an embezzler is not entitled to the benefits of a deduction under § 172 when embezzled funds are repaid, and that even if an embezzler were entitled to the benefits of the deduction under § 172 for the repayment of the embezzled funds, the plaintiff in the instant suit has not shown that he was in the trade or business of embezzling.

Plaintiff contends that if he is not entitled to a deduction under § 172 for a loss in connection with a trade or business which would entitle him to a net operating loss carryback, then in the alternative, he is entitled to the tax benefits available under § 1341 which provide a special tax benefit rule if an item was included in gross income for a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item and it is then determined in a later tax year that the taxpayer did not have an unrestricted right to the item included in income. The crucial issue, for the purpose of this case,

is whether Plaintiff had an unrestricted right to the embezzled money in 1966, or as the question is otherwise stated, whether the Plaintiff had a claim of right to the money which he embezzled in 1966. If the Plaintiff held the embezzled money under a claim of right, then he would be entitled to the tax benefits of § 1341.

The crucial issue is whether or not embezzled money can ever be held under a claim of right, and if so, whether or not the Plaintiff, in fact, held this embezzled money under a claim of right. In *Commissioner v. Wilcox* [46-1 USTC ¶ 9188], 327 U. S. 404 (1946) the Supreme Court held that an embezzler who had obtained money without any claim of right did not have any taxable income as a result of the embezzlement. The opinion implied that embezzled funds could never be acquired in a manner that would constitute being obtained with a claim of right. In *James v. United States* [61-1 USTC ¶ 9449], 366 U. S. 213 (1961), the Supreme Court overruled the holding of the *Wilcox* case, holding that embezzled money must be included in gross income whether or not the embezzler held the money under a claim of right. The heart of the argument that an embezzler is entitled to § 1341 tax benefits upon the repayment of embezzled money must rest on the contention that when the Supreme Court overruled the *Wilcox* holding that embezzled funds were not gross income, it also reversed the *Wilcox* decision that an embezzler does not hold embezzled funds under a claim of right.

It seems almost too clear for argument that funds received through embezzlement and held by an embezzler are not held under a claim of right or with the appearance that the embezzler has an unrestricted right to the use of the embezzled funds. Furthermore, Plaintiff's argument that he held the embezzled funds under a claim of right and therefore is entitled to § 1341 benefits is made more doubtful by the fact that Plaintiff has previously indicated that he did not believe he held the funds in question under a claim of right. In a claim for refund filed with the Internal Revenue Service on April 14, 1970, (when Plaintiff apparently believed that it would be to his benefit to so state), that Plaintiff admitted that the embezzled funds "did not belong to me in 1966." (Defendant's exhibit "H"). Furthermore, Plaintiff admitted in a protest filed with the Internal Revenue Service on February 24, 1971, (also when he thought the argument would be to his benefit), that "the unlawful earnings acquired by me, if any, and if at any time, were not held by me without restriction as to their disposition". (Defendant's exhibit "I"). Thus, even if it were possible for embezzled funds to be held under a claim of right, the Plaintiff has previously admitted that he did not hold the embezzled funds in question under a claim of right. Plaintiff also admitted in testimony adduced at trial that he included the embezzled funds in income in 1966 not because he believed that he held them under a claim of right, but because he knew of the Supreme Court's holding in the *James* case and therefore

included them in income because the Supreme Court had required embezzled funds to be included in income.

The Court is of the opinion that, even if Plaintiff had consistently claimed that he held the embezzled funds in question under a claim of right and had an unrestricted right to use the funds, and so believed nevertheless embezzled funds cannot, as a matter of law, be held by an embezzler under a claim of right such as to qualify for the § 1341 tax benefit provisions, if and when they are repaid. The decision of the Supreme Court in *James* cannot properly be read to say that the Supreme Court concluded that embezzled funds are held under a claim of right. On the contrary, *James* does not in any way contradict or weaken the Court's statement in *Wilcox* that embezzled funds are not held under a claim of right; it only says that this is immaterial in determining whether embezzled funds must be included in gross income. It is important to note that the Court does not say in *James* that whether embezzled funds are held under a claim of right or not is of no tax importance. The Court only said that the claim of right doctrine is of no importance in determining whether embezzled funds must be included in gross income. Thus, there is no Supreme Court case that either holds or implies that Plaintiff ought to be entitled to the benefits of § 1341 because he held the embezzled funds under a claim of right, and in fact, a careful reading of *Wilcox* and *James* seems to imply just the opposite. The Internal Revenue Service has long interpreted § 1341 as not applying

to the repayment of embezzled funds. Rev. Rul. 65-254, 1965-2 Cum. Bull. 50. In addition, every court that has faced this issue has denied the embezzler the benefits of § 1341. See *Hankins v. United States* [75-2 USTC ¶ 9746], 36 A. F. T. R. 2d 6008 (N. D. Miss. September 25, 1975). It should also be noted that the same policy and comity considerations that militate against giving the Plaintiff the benefits of § 172 also militate against giving him the benefits of § 1341. Thus, the Court holds that as a matter of law the repayment of embezzled funds is not entitled to the § 1341 tax benefit because embezzled funds are not held under a claim of right, and that even if embezzled funds could be held under a claim of right, the Plaintiff in the instant suit did not hold the embezzled funds under a claim of right.

In conclusion, the Court can find no basis in either law or fact for giving the Plaintiff the benefits of § 172 and the net operating loss available for expenses and losses incurred in connection with a trade or business or the tax benefits of § 1341 for funds included in income because it appeared that they were held under a claim of right and then subsequently repaid because it was determined in a later tax year that the funds were not held under a claim of right and therefore were not properly includable in the taxpayer's income in the prior year. The only tax benefit to which the Plaintiff was entitled for the repayment of the embezzled funds in 1969 was a deduction under § 165 (c)(2) of the Internal

Revenue Code for a loss incurred in a transaction entered into for profit, although not connected with a trade or business, and the IRS gave Plaintiff this deduction. Although the Plaintiff did not receive the type of tax benefit that he desired from the § 165 deduction, it is the only deduction to which he is entitled. Accordingly, it is

ORDERED, ADJUDGED AND DECREED that judgment be, and hereby is, GRANTED for Defendant, and that the relief requested by the Plaintiffs be, and hereby is, DENIED. This Memorandum Opinion and Order shall constitute findings of fact and conclusions of law.

HERMAN E. AND MARY E. McKINNEY,
PLAINTIFFS-APPELLANTS,

v.

UNITED STATES OF AMERICA,
DEFENDANT-APPELLEE.

No. 76-4260.

United States Court of Appeals,
Fifth Circuit.

June 13, 1978

Taxpayer, who reported and paid taxes on embezzled money, and who then refunded entire amount, sought to be made whole tax-wise under terms of special statutory relief provision. The United States District Court for the Western District of Texas at Austin, Jack Roberts, J., entered judgment against taxpayer, and taxpayer appealed. The Court of Appeals, Tuttle, Circuit Judge, held that taxpayer, who had no right to embezzled funds, much less "an unrestricted right" to them as required, was not entitled to full benefit of deduction in year of repayment that would effectively wipe out economic loss suffered from prior payment of taxes on illegally acquired funds.

Affirmed.

It could not have appeared to taxpayer, who after refunding entire amount of embezzled funds sought to be made whole tax-wise under terms of special statutory relief provision for taxes he paid on such funds, that he had any right to the funds, much less "an unrestricted right" to them as required, and thus taxpayer, whose entitlement to deduction for year of repayment was not disputed, was not entitled to full benefit of deduction in year of repayment that would effectively wipe out economic loss suffered from prior payment of taxes on illegally acquired funds. 26 U.S.C.A. (I.R.C.1954) §§ 1341, 1341(a)(1).

Appeal from the United States District Court for the Western District of Texas.

Before TUTTLE, GEE and FAY, Circuit Judges.

TUTTLE, Circuit Judge:

The taxpayer,[1] Herman E. McKinney, having embezzled the sum of $91,702.06 from his employer, reported and paid taxes on the fund in 1966. He

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1/ Taxpayer's wife is included in this civil claim because he filed a joint return for the relevant tax year.

refunded the entire amount in 1969 and now seeks to be made whole tax-wise under the terms of a special statutory relief provision of the Internal Revenue Code, 26 U.S.C. § 1341.

The facts are not in dispute. Over a period of years McKinney, who was employed by the Texas Employment Commission, arranged matters in such a manner that in 1966 he was able to siphon off $91,702.06 of the state's money. Because of the requirements of the federal taxing statutes following the Supreme Court's decision in *James v. United States*, 366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246 (1961), McKinney reported the embezzled funds as "miscellaneous income" on his 1966 federal income tax return. Subsequently, the embezzlement was discovered, and McKinney was convicted in the state courts of embezzlement. He repaid the embezzled funds in 1969. On his tax return for that year, taxpayer claimed a deduction for this repayment as a trade or business loss, resulting in a reported "net operating loss" for that year. He then claimed a net operating loss carryback deduction for 1966. Alternatively, taxpayer filed a claim for refund for 1969, claiming the benefit of the provisions of § 1341.[2]

2/ Section 1341. Computation of tax where taxpayer restores substantial amount held under claim of right

(a) General Rule.--If--

The Government does not dispute the taxpayer's entitlement to a deduction for the year 1969, but this does not give him the full benefits that would be enjoyed if he could treat the loss as if it had occurred in 1966, the year of payment. The taxpayer has abandoned his original claim that he is entitled to a carryback of the loss as a "net operating loss," a point decided against him by the trial court. He therefore relies solely on his contention that by the enactment of § 1341, Congress intended that a taxpayer, who reported as income funds acquired by theft or embezzlement, be able to obtain, if required subsequently to refund the amounts, the full benefit of a deduction in the year of repayment that would effectively wipe out the economic loss suffered from the prior payment of taxes on the illegally acquired funds.

In 1954, Congress enacted § 1341 to alleviate perceived inequities created

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(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

by operation of the so-called "claim-of-right doctrine." The classic formulation of the doctrine is that:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

North American Oil Consolidated v. Burnet, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197 (1952) (emphasis added). The statute merely allows, as an alternative to a deduction in the year of repayment, taxes for the current year to be reduced by the amount taxes were increased in the year of receipt because the funds in question were included in gross income.

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(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

(4) the tax for the taxable year computed with such deduction; or

(5) an amount equal to--

26 U.S.C. Section 1341.

The Court first applied the doctrine in the context of embezzled funds in *Commission of Internal Revenue v. Wilcox*, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752 (1946). In *Wilcox* the IRS argued that embezzled funds should be treated as taxable income to the wrongdoer under § 22(a) of the Code. The Court disagreed. After noting that the essence of taxable income is "the accrual of some gain, profit or benefit to the taxpayer," *Id.* at 407, 66 S.Ct. at 548, the Court held:

> For present purposes . . . it is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, . . . the taxpayer cannot be said to have received any gain or profit within the reach of § 22(a).
>
> * * * * * * * * * * *
>
> It is obvious that the taxpayer in this instance, in embezzling the $12,748.60, received the money without any semblance of a bona fide claim of right. And he was at all times under an unqualified duty and obligation to repay the money . . ..

Id. at 408, 66 S.Ct. at 549 (emphasis added) (citation omitted). On this basis the Court concluded that embezzled money did not constitute taxable income to the embezzler.

Fifteen years later, the Court expressly overruled *Wilcox* in *James v. United States*, 366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246 (1961). The Court reasoned:

> A gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it," *Rutkin v. United States*, [343 U.S. 130, 137, 72 S.Ct. 571, 575, 96 L.Ed. 833]. Under these broad principles, we believe that petitioner's contention, that all unlawful gains are taxable except those resulting from embezzlement, should fail.
>
> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." *North American Oil Consolidated v. Burnet*, [286 U.S. 417,

> 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197]. *Corliss v. Bowers*, [281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916]. This standard brings wrongful appropriations within the broad sweep of "gross income" . . ..

Id. at 219, 81 S.Ct. at 1055.

Because the benefit conferred by the statute depends upon whether it "appear[s] that the taxpayer had an unrestricted right to such item," it is necessary for us to determine whether in its *James* decision, the Supreme Court modified its conclusion in *Wilcox* that in embezzling funds a taxpayer "received the money without any semblance of a bona fide claim of right", 327 U.S. at 408, 66 S.Ct. at 549, or whether the Court merely said that embezzled funds are to be returned for tax purposes as part of gross income regardless of whether they were held under a "claim of right."

We agreed with the reasoning of the trial court here:

> The decision . . . in *James* cannot properly be read to say that the Supreme Court concluded that embezzled funds are held under a claim of right. On the contrary, *James* does not in any way contradict or weaken the Court's statement in *Wilcox* that embezzled funds

> are not held under a claim of right; it only says that this is immaterial in determining whether embezzled funds must be included in gross income.

The *James* Court merely held that the term "gross income" in the tax statute was broad enough to include money received "when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it," 366 U.S. at 219, 81 S.Ct. at 1055, without regard to whether its recipient had a "claim of right" to the funds.

Since the language of § 1341 makes its benefits available to a taxpayer only if he "had an unrestricted right to such item", we agree with the trial court that the plain language of the statute prevents its application in favor of appellant. The language of § 1341(a)(1), i.e. "because it appeared that the taxpayer had an unrestricted right to such item", must necessarily mean "because it appeared [to the taxpayer] that [he] had an unrestricted right to such item." When the item was embezzled funds it is clear that it could not appear to the taxpayer that he had any right to the funds, much less "an unrestricted right" to them.

This contention is consistent too with the applicable regulations:

> (a) In general. (1) If, during the taxable year, the taxpayer is entitled . . . to a deduction of more than $3,000 because of the restoration to another of an item which was included in the taxpayer's gross income for a prior taxable year . . . under a claim of right, the tax imposed . . . shall be . . ..
>
> (2) For the purpose of this section "income included under a claim of right" means an item included in gross income because it appeared from all the facts available in the year of inclusion that the taxpayer had an unrestricted right to such item . . ..

Treas. Reg. §§ 1.1341-1(a)(1), (2) (emphasis added).

The taxpayer contends that, notwithstanding the plain meaning of the words, the statute should be interpreted to read that whenever gains are enjoyed by a taxpayer which, under applicable laws, he is required to report as income, this requirement of itself converts such gains into income held under a "claim of right." The chronology of the two Supreme Court cases and the enactment of this statute precludes such a determination. At the time this statute was enacted, *Wilcox* was the law. Embezzled funds were not reportable as income. It could not have been the intent of Congress to give the benefits of this new

relief section to holders of embezzled funds.

Our conclusion comports with the prior affirmance by us of the judgment of the district court in *Hankins v. United States*, 403 F.Supp. 257 (N.D. Miss. 1975). In that case, on facts identical to those in the present case, the district court held:

> [A]s an embezzler, plaintiff never received his employer's funds under a claim of right and the benefits of Section 1341 of the Code (26 U.S.C. § 1341) are not available to him.

Id. at 259. Our court affirmed *Hankins* without opinion. 531 F.2d 573 (5th Cir. 1976). Since it is not clear that the trial court in *Hankins* was required to pass on the precise issue before us, we consider it appropriate to deal with the matter at greater length here.

The judgment is AFFIRMED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 76-4260

HERMAN E. AND MARY E. McKINNEY,
PLAINTIFFS-APPELLANTS,

v.

UNITED STATES OF AMERICA,
DEFENDANT-APPELLEE.

Appeal from the United States District Court for the Western District of Texas

ON PETITION FOR REHEARING
July 31, 1978

Before TUTTLE, GEE and FAY,
Circuit Judges.

Per Curiam:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT:

_____
United States Circuit Judge

No. 78-700

In the Supreme Court of the United States

OCTOBER TERM, 1978

HERMAN AND MARY E. MCKINNEY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-700

HERMAN AND MARY E. McKINNEY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this federal income tax case is whether petitioner[1] is entitled to the special relief provisions of Section 1341 of the Internal Revenue Code of 1954 with respect to his repayment of embezzled funds included in income for an earlier year.

The pertinent facts are as follows: Petitioner embezzled $91,702.06 from his employer in 1966, and reported this amount as "miscellaneous income" on his federal income tax return for that year. The embezzlement was thereafter discovered, and petitioner was convicted of embezzlement in a state court. He repaid the embezzled funds in 1969. On his return for that later year, petitioner claimed a

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[1]References to petitioner are to Herman McKinney. His wife, Mary E. McKinney, is a party to this case solely because she filed a joint return with her husband for the year at issue.

deduction for the repayment as a loss incurred in carrying on a trade or business. This resulted in a claimed "net operating loss" for 1966, which petitioner sought to carry back to 1966. Alternatively, petitioner claimed entitlement to the benefit of Section 1341 for 1969 (Pet. App. 12a-13a). Under Section 1341, where a taxpayer repays an amount "included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item" and the deduction allowable for such a repayment would exceed $3,000, the tax for the year of repayment is the lesser of (1) the tax computed with such deduction or (2) the tax computed without such deduction reduced by the amount of tax paid for the earlier year (or years) attributable to the original inclusion of the amount in question in gross income. If such additional tax for the earlier year exceeds the tax for the repayment year, computed without a deduction for the repayment, the excess is treated as an overpayment for the latter year. See Treasury Regulations on Income Tax, Section 1.1341-1(i) (26 C.F.R.).

On audit, the Commissioner of Internal Revenue determined that petitioner's repayment of the embezzled funds was deductible only as a loss from a transaction entered into for profit under Section 165(c)(2) and not as a business expense under Section 162(a). He further determined that Section 1341 was inapplicable. As a result, petitioner could only deduct the repayment in the year it was made (1969) and could not carry it back to 1966, the year at issue.[2] In this refund suit brought by petitioner in the United States District

[2]Apparently, petitioner did not have sufficient income in 1969 to derive any advantage from the deduction available for that year. Individual taxpayers cannot take nonbusiness losses into account in determining the amount of their net operating loss deduction to be carried back or forward to other years. See Sections 172(c) and (d)(4).

Court for the Western District of Texas, the district court rejected petitioner's claim that he was entitled to an adjustment for 1969 under Section 1341. The court ruled that embezzled funds are not held under a "claim of right" and that petitioner did not have "an unrestricted right" to the embezzled funds within the meaning of Section 1341 (Pet. App. 5a-10a). The court of appeals affirmed (Pet. App. 12a-21a).[3]

Section 1341 was enacted in 1954 to alleviate certain inequities resulting from the operation of the "claim of right" doctrine under which amounts received under a claim of right must be included in income in the year received, even though they are subsequently returned because the claim was invalid. See *North American Oil* v. *Burnet*, 286 U.S. 417 (1932); *United States* v. *Lewis*, 340 U.S. 590 (1951); H.R. Rep. No. 1337, 83d Cong., 2d Sess. 86, A294-A295 (1954). As an alternative to a deduction in the year of repayment, Section 1341 allows a reduction in the taxes for the repayment year equal to the increase in taxes in the year of receipt attributable to the inclusion in that year of the income item in question.

In order to claim the benefit of Section 1341, the taxpayer must show that the item of income was reported in a prior year "because it appeared that the taxpayer had an unrestricted right to such item." Section 1341(a)(1). The statutory phrase "unrestricted right" to income refers to income held under a "claim of right" (see

[3]The district court also held that petitioner's repayment of the embezzled funds was not deductible as a business expense because his occasional embezzlement activities did not constitute a "trade or business" (Pet. App. 4a-5a). Accordingly, the court upheld the government's position that the repayment of the embezzled funds gave rise only to a nonbusiness loss deduction under Section 165(c)(2) of the Code (Pet. App. 1a-12a). Petitioner did not question this aspect of the district court's decision in the court of appeals and does not seek review of it by this Court.

H.R. Rep. No. 1337, *supra;* Treasury Regulations, Section 1.1341-1(a)). However, it has long been established that an embezzler has no claim of right to embezzled funds. *Commissioner* v. *Wilcox*, 327 U.S. 404 (1946). The courts have therefore consistently held that Section 1341 is not applicable to the repayment of embezzled funds. *Hankins* v. *United States*, 403 F. Supp. 257 (N.D. Miss. 1975), aff'd, 531 F. 2d 573 (5th Cir. 1976); *Yerkie* v. *Commissioner*, 67 T.C. 388 (1976). *Hauser* v. *Commissioner*, 29 T.C.M. 908 (1970).

Petitioner's principal contention (Pet. 7-8) is that in *James* v. *United States*, 366 U.S. 213 (1961), the Court overruled its earlier determination in *Commissioner* v. *Wilcox*, *supra*, that embezzled funds are not held under a claim of right. But petitioner misreads the import of *James*. In *Wilcox*, the Court held that embezzled funds did not constitute income to the embezzler because he had no bona fide claim of right to such funds. In *James*, the Court held that embezzled funds are income under the broad definition of Section 61 of the Code. However, it did not so hold on the ground that such funds are held under a claim of right but rather on the basis of the economic benefit derived by the embezzler from the embezzlement. Indeed, in *James* the Court reaffirmed its earlier conclusion in *Wilcox* that embezzled funds are not held under a claim of right (366 U.S. at 216). Thus, as the court below correctly recognized (Pet. App. 18a-19a), *James* does not hold that embezzled funds are held under a claim of right.[4]

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[4]Nor does *Healy* v. *Commissioner*, 345 U.S. 278 (1953) (Pet. 4-7), support petitioner's position that embezzled funds are held under a claim of right. The Court there (p. 282) simply reaffirmed its earlier decision in *United States* v. *Lewis*, *supra*, that "a mistaken claim is nonetheless a claim" for purposes of the claim of right doctrine. Petitioner, however, never had any claim, mistaken or otherwise, to the funds he embezzled.

Contrary to petitioner's first argument (Pet. 8-9), the decision below does not conflict with *Quinn* v. *Commissioner*, 524 F. 2d 617 (7th Cir. 1975). The application of Section 1341 was not at issue in *Quinn*. The only question there was whether the embezzlement of funds gives rise to taxable income where, in the same year the embezzlement occurs, the embezzler acknowledges an obligation to repay the funds. The court correctly held that actual repayment—not simply recognition of an obligation to repay—was necessary to create an offsetting deduction to the amount realized from the embezzlement. Although the court stated (524 F. 2d at 623) that James expanded the claim of right doctrine to include embezzled funds, this statement was not only erroneous but also was unnecessary to the decision because embezzled funds constitute income under *James* without regard to whether they are received under any claim of right.

Accordingly, it is respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

DECEMBER 1978

DOJ-1978-12